



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9633]

RIN 1545-BE58

Limitations on Duplication of Net Built-in Losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 362(e)(2) of the Internal Revenue Code of 1986 (Code). The regulations apply to certain nonrecognition transfers of loss property to corporations. The regulations affect all parties to the transaction.

DATES: Effective Date: These final regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability see §1.358-2(d), §1.362-4(j).

FOR FURTHER INFORMATION CONTACT: Theresa A. Abell (202) 622-7700 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under OMB control number

1545-2247. The collection of information in these final regulations is in §1.362-4(d). This information is required by the IRS to verify basis of property transferred in certain tax-free transactions when taxpayers make the election provided for under section 362(e)(2)(C).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

Section 362(e)(2) was enacted in the American Jobs Creation Act of 2004 (Public Law 108-357, 188 Stat. 1418 (2004)) in order to prevent the duplication of loss in certain corporate nonrecognition transfers. Section 362(e)(2) applies to corporate acquisitions of property with a net built-in loss in transactions described in section 362(a) (transactions to which section 351 applies and acquisitions of property as paid-in surplus or contributions to capital), but only if the transaction is not described in section 362(e)(1) (transactions in which there is an importation of built-in loss). When a transaction is subject to section 362(e)(2), the acquiring corporation's basis in loss property is reduced by the property's allocable portion of the transferor's net built-in loss. See section 362(e)(2)(B). However, under section 362(e)(2)(C), the parties to the transaction can make an irrevocable election to apply the reduction to the transferor's

basis in the stock received in the exchange instead of to the transferee's basis in the property received in the exchange.

Notice 2005-70, 2005-2 CB 694, was published on October 11, 2005, to provide interim guidance for making an election to apply section 362(e)(2)(C). See §601.601(d)(2) of this chapter. Under Notice 2005-70, an election would be considered effective once a certification was included by the transferor or, if the transferor is a controlled foreign corporation (CFC), by all of its controlling U.S. shareholders as defined in § 1.964-1(c)(5), on a timely filed original Federal income tax return (designated a "U.S. return" under the final regulations) for the year of the transaction. Notice 2005-70 expressly permitted taxpayers to make a protective election that would have no effect on a transaction that is ultimately not subject to section 362(e)(2). The Notice also allowed other statements to be treated as effective elections if sufficient information was provided to the IRS with respect to the transfer and parties.

Proposed regulations under section 362(e)(2) were published in the **Federal Register** (71 FR 62067) on October 23, 2006. Following the publication of the proposed regulations, the IRS received questions concerning the application of section 362(e)(2) to transactions involving S corporations and partnerships and concerning the filing of the section 362(e)(2)(C) election, particularly with respect to transactions between persons outside the United States. The IRS also has become aware of certain ambiguities (described later in this preamble) relating to the proper operation of the statute. Two written comments were submitted; no public hearing was requested or held.

Summary of Proposed Regulations

1. General Application of Section, Interaction with Other Law

The proposed regulations included a number of specific provisions regarding the general operation of the statutory framework, such as provisions stating that section 362(e)(2) is to be applied on a transferor-by-transferor basis; that a transaction is treated as subject to section 362(e)(2) to the extent it is not a transfer of net built-in loss property under section 362(e)(1); that gain recognized by the transferor is taken into account in determining the transferee's basis immediately after the transfer; and that section 362(e)(2) applies to any transaction described in section 362(a) without regard to whether the transaction is also described in section 362(b) or any other section. These provisions responded to inquiries from practitioners concerning section 362(e)(2) and its interaction with generally applicable provisions of the Code.

2. Exceptions From the Application of Section 362(e)(2)

The proposed regulations included two exceptions under which a transaction would be treated as not subject to section 362(e)(2) notwithstanding that the transaction is generally described in that section.

Under the first exception, if a transfer is not relevant for Federal income tax purposes at the time it occurs and it does not become relevant for Federal income tax purposes at any time within two years of the transfer, then, solely for purposes of determining whether section 362(e)(2) applies to the transaction, the property exchanged would be deemed to have a basis equal to its fair market value (designated value under the final regulations) immediately after the transaction. As a result, the transfer would not be subject to section 362(e)(2). This exception reflected a concern that transferors not anticipating that a transfer would be relevant for Federal income tax

purposes would not be likely to undertake the valuation and record-keeping necessary to comply with the statute. However, if a transfer that was not relevant for Federal income tax purposes when it occurred became relevant for Federal income tax purposes at any time within two years of the transfer, the administrative burden of compliance would not be unreasonable, and, if a transaction was undertaken with a view to reducing or avoiding Federal income tax, the transferor must expect the transfer to be relevant for Federal income tax purposes. Because relief would be either unnecessary or inappropriate in either case, relief was not extended to those cases.

Under the second exception, a transaction would not be subject to section 362(e)(2) to the extent that the transferor distributes the stock received in the transaction and, in the distribution, no gain or loss was recognized and no person takes the stock or other property with a basis determined by reference to the transferor's basis in the distributed stock. This relief reflected a determination that, to the extent there is no duplicated loss that could be recognized by any taxpayer, section 362(e)(2) should not apply to the transaction.

3. Securities received without the recognition of gain or loss

Section 362(e)(2) is silent with respect to securities received without the recognition of gain or loss in a transaction otherwise subject to section 362(e)(2). However, the IRS and Treasury Department determined that the statutory purpose of preventing loss duplication would be circumvented if section 362(e)(2) did not apply to securities issued in such cases. For example, if loss property is transferred in exchange for stock and securities and any part of the securities are retained following the distribution of the stock under section 355, loss would be duplicated and preserved in

the retained securities. To prevent this circumvention of the statutory purpose, the proposed regulations defined the term “stock” to include both stock and securities for purposes of section 362(e)(2).

4. Liabilities

In general, as illustrated in Example 5 in paragraph (d) of §1.362-4 of the proposed regulations, liabilities assumed in the transaction do not affect the application of section 362(e)(2). However, the proposed regulations provided that, if a section 362(e)(2)(C) election is made, the reduction to stock basis is limited to the amount that the transferee would otherwise reduce its basis in the transferred assets. This was intended to prevent the reduction of stock basis attributable to contingent liabilities associated with a trade or business, for which basis is specifically preserved under section 358(h)(2)(A).

5. The Section 362(e)(2)(C) Election

The proposed regulations adopted the general approach of Notice 2005-70, treating an election as effective if the transferor files a certification (designated the “election statement” in the proposed regulations) on its U.S. return for the year of the transfer or, if the transferor is a CFC, if the controlling U.S. shareholders all file the election statement on or with their U.S. returns. The proposed regulations also adopted the rule allowing a protective election.

In addition, the proposed regulations substantially expanded the guidance provided in Notice 2005-70. The proposed regulations added an express requirement that the transferor and the transferee execute a written, binding agreement. The proposed regulations also included guidance on the filing of an election statement in

circumstances not addressed in the Notice (for example, if the transferor was not required to file a U.S. return and was not a CFC) and provided that the statement must be filed in accordance with the regulations in order for the section 362(e)(2)(C) election to be effective.

In addition, the proposed regulations provided that the basis tracing provisions in §1.358-2 would not apply to transactions in which a section 362(e)(2)(C) election is made. Thus, if A transferred multiple shares of X stock to Y in a transaction subject to section 362(e)(2), the Y shares received in the transaction would each be allocated an equal portion of A's aggregate basis in the X shares transferred, without regard to A's bases in the individual shares of X stock surrendered. As a result, there would be no disparity among A's bases in its Y shares following a section 362(e)(2)(C) election. This rule was intended to prevent a preservation of loss that would be contrary to the objective of section 362(e)(2).

6. Partnerships and S Corporations

The proposed regulations confirmed that any reduction under section 362(e)(2)(C) to the basis in stock received by a partnership or S corporation in a transaction subject to section 362(e)(2) is an expenditure or expense of the transferor partnership or S corporation. As a result, the section 362(e)(2)(C) stock basis reduction would cause a reduction to the basis of the partner in its interest in the partnership or the S corporation shareholder's basis in its stock of the S corporation.

Summary of Comments and Guidance

In general, the commenters concurred with the positions taken in the proposed regulations, but requested that the overall operation of the statute be clarified. For

example, since the issuance of the proposed regulations, the IRS has become aware of certain questions relating to the allocation of net built-in loss where gain is recognized and multiple properties are transferred in the transaction. In addition, practitioners requested further guidance on the application of section 362(e)(2) to transactions that are also subject to section 362(e)(1), to transactions involving partnerships and S corporations, and to transactions between persons not connected with the United States, particularly with regard to the making of the section 362(e)(2)(C) election.

Accordingly, these final regulations generally adopt the substantive rules of the proposed regulations. In addition, the final regulations revise the structure of the proposed rules to clarify the application of section 362(e)(2) and to provide a framework that will better coordinate with the provisions of section 362(e)(1) and the regulations that are to be promulgated under that section. These are not substantive changes from the proposed regulations but are solely intended to simplify the application of section 362(e)(2). The material changes and additions to the proposed regulations are as follows:

1. Clarification of Overall Application of Section 362(e)(2)

The final regulations adopt a general operative rule and related definitions to facilitate the identification of transactions that are subject to section 362(e)(2) and to then determine the tax treatment required by this section. This approach responds to comments requesting more clarity on the general operation of the provision.

The general operative rule set forth in the final regulations is that whenever a person (Transferor) transfers property to a corporation (Acquiring) in a loss duplication transaction, Acquiring's basis in each loss duplication property (as determined without

regard to section 362(e)(2)) is reduced by the property's allocable portion of Transferor's net built-in loss.

The final regulations define the term "loss duplication transaction" as any section 362(a) transfer in which Acquiring's aggregate basis in the property transferred by Transferor would exceed the aggregate value of such property immediately after the transaction. The term "loss duplication property" refers to individual property transferred in the loss duplication transaction that Acquiring would take with a basis that would exceed value immediately after the transfer. Finally, the term "Transferor's net built-in loss" is defined as the excess of Acquiring's aggregate basis in property received from Transferor over the aggregate value of such property immediately after the transaction. For purposes of applying each of these definitions, Acquiring's basis in property is determined immediately after the transfer, disregarding section 362(e)(2) but taking into account all other applicable rules, including section 362(e)(1).

The final regulations thus incorporate in the operative rules and definitions the transferor-by-transferor approach and other general provisions that reflect the statutory construct as implemented by the proposed regulations, including that a transfer can be subject to both section 362(e)(1) and section 362(e)(2) and the priority given to section 362(e)(1) in such cases. These principles are further illustrated in the examples.

2. Additional Definitions

Several questions were raised concerning whether certain persons were required to file a U.S. return within the meaning of the regulations. To address these concerns, the final regulations define the term "U.S. return" as a return of income that must be filed under section 6012 or an information return that must be filed under Subtitle F, Chapter

61, Subchapter A, Part III of the Code (sections 6031 and following). The final regulations further provide that the requirement to file the return must be unconditional. Thus, the term does not include forms that are merely elective to receive a particular tax treatment, such as statements filed to make an election or to reduce or avoid withholding by a person not otherwise required to file a U.S. return. These changes are intended to eliminate uncertainty as to whether a person has a filing requirement for purposes of determining whether a transaction qualifies for relief as a transaction outside the United States. The final regulations also clarify the time for filing and the person that must file a statement that the Transferor and Acquiring are making an election under section 362(e)(2)(C) (designated as a “Section 362(e)(2)(C) Statement” under the final regulations). The Section 362(e)(2)(C) Statement is described more fully later in this preamble.

The final regulations modify the definition of the term “controlling U.S. shareholder.” Under the final regulations, only persons owning a direct interest in the CFC or an interest treated as owned by reason of an interest in a partnership, estate, trust, or corporation are treated as controlling U.S. shareholders. This change reflects a concern that, for this purpose, a rule treating persons as controlling U.S. shareholders solely by reason of the family attribution rules presents undue administrability concerns and can cause inappropriate results in certain cases.

3. Exception for Transactions Outside the U.S. Tax System

The IRS and Treasury Department continue to believe that administrative relief is appropriate when the parties to the transfer do not expect the transfer to be relevant for Federal tax purposes, and in fact the transfer does not become relevant for Federal tax

purposes within two years of the transfer. Accordingly, the final regulations retain the rule in the proposed regulations excepting transactions wholly outside the U.S. tax system. However, the final regulations conform the formulation of the rule to the formulation of the exception for transactions in which duplicated loss is eliminated. That is, the rule in the final regulations does not presume that basis and value are equal (with the result that no loss is transferred and so section 362(e)(2) does not apply), as in the proposed regulations, but instead provides simply that section 362(e)(2) will not apply to a qualifying transaction. Like the proposed regulations, the final regulations provide that a transaction will qualify for this exception only if the transaction is between persons not connected to the United States, the transaction does not become relevant for Federal tax purposes within two years of the transfer, and the transaction is not undertaken pursuant to a plan to reduce or avoid Federal taxes.

4. Controlled Foreign Partnerships (CFPs)

The IRS and Treasury Department have determined that, for purposes of the administrative relief granted for transactions outside the United States, as well as for purposes of determining the person that must file a Section 362(e)(2)(C) Statement, CFPs should be treated in the same manner as CFCs. First, the reason that CFCs are ineligible for relief is that a CFC could not reasonably expect a transfer to have no relevance for Federal income tax purposes, and so the administrative relief is not warranted. The same is true with respect to CFPs. Second, with respect to the filing of a Section 362(e)(2)(C) Statement, although a CFP may not be required to file a U.S. return, the reporting U.S. partners of a CFP have a relationship to the CFP, and a filing obligation with respect to the CFP's activities, that is materially the same as that of the

controlling U.S. shareholders of a CFC. Thus, the reporting U.S. partners of a CFP have the same reporting requirements under these final regulations as the controlling U.S. shareholders of a CFC. For purposes of these final regulations, a partnership is a CFP if it is treated as such for purposes of section 6038; a CFP's reporting U.S. partners are generally those persons that would be required to file an information return with respect to the CFP under section 6038.

5. Liabilities

The final regulations retain the approach in the proposed regulations that generally disregards liability assumptions. Example 5 in paragraph (d) of the proposed regulations §1.362-4 is expanded, however, to illustrate more fully the application of section 362(e)(2) to transactions in which fixed and contingent liabilities are assumed. See Example 5 in paragraph (h) of the final regulations §1.362-4.

However, in both written comments and informal inquiries, practitioners have raised concerns about the effect of this rule when the property transferred is an interest in a partnership with liabilities. In particular, practitioners are concerned because partnership liabilities increase each partner's basis in its partnership interest but do not give rise to a corresponding increase in the value of those interests. The result can be the appearance of a built-in loss.

To address this problem, the final regulations generally adopt the approach proposed by commentators, specifically, by modifying the definition of the term "value" (generally, fair market value) to take liabilities into account when determining whether a partnership interest is a loss asset. However, because there can be differences between Transferor's share of partnership liabilities and Acquiring's share of partnership

liabilities, the final regulations provide that the value of a partnership interest is the sum of cash that Acquiring would receive for such interest, increased by any §1.752-1 liabilities (as defined in §1.752-1(a)(4)) of the partnership that are allocated to Acquiring with regard to such transferred interest under section 752. The final regulations include an example that illustrates the application and effect of this rule. See Example 8(ii) in paragraph (h) of the final regulations §1.362-4. The final regulations also clarify that any section 743(b) adjustment to be made as a result of the transaction is made after any section 362(e) basis adjustment.

6. Elections under Section 362(e)(2)(C)

Since the enactment of section 362(e)(2), the questions most frequently asked of the IRS concern the making of the section 362(e)(2)(C) election, notwithstanding the publication of Notice 2005-70 and the proposed regulations. Accordingly, the final regulations not only generally adopt the rules set forth in Notice 2005-70 and in the proposed regulations, but they also expand those rules significantly to address the questions raised.

a. Section 362(e)(2)(C) Statement

To begin, the final regulations retain the fundamental structure of the proposed regulations. Thus, under the final regulations, a written, binding agreement to make a section 362(e)(2)(C) election must be executed by Transferor and Acquiring, and a Section 362(e)(2)(C) Statement must be filed in accordance with the regulations. A section 362(e)(2)(C) election is effective only if both conditions are met. The final regulations do not prescribe a particular form for the agreement to make the section

362(e)(2)(C) election; however, the final regulations do require the written, binding agreement to be in effect prior to the time a Section 362(e)(2)(C) Statement is filed.

The final regulations generally adopt the structure of the proposed regulations regarding the time and manner of filing of the Section 362(e)(2)(C) Statement. Thus, under the final regulations, the statement is filed by Transferor (if Transferor is otherwise required to file a U.S. return for the year of the transaction) or by all of Transferor's controlling U.S. shareholders or reporting U.S. partners (if Transferor is a CFC or CFP at the time of the transaction and is not otherwise required to file a U.S. return). Further, if Transferor is not otherwise required to file a U.S. return and is not a CFC or CFP, then the statement is filed by Acquiring (if Acquiring is otherwise required to file a U.S. return in the year of the transaction) or by all of Acquiring's controlling U.S. shareholders (if Acquiring is a CFC at the time of the transaction and is not otherwise required to file a U.S. return).

Unlike the proposed regulations, the final regulations do not require or permit the filing of the Section 362(e)(2)(C) Statement by a U.S. person (as defined in section 7701(a)(30)) that is not otherwise required to file a U.S. return. This change was made because these regulations do not create an independent filing requirement, and not all U.S. persons would otherwise be required to file a U.S. return.

b. Neither party able to file a Section 362(e)(2)(C) Statement

Like the proposed regulations, the final regulations provide rules regarding the filing of a Section 362(e)(2)(C) Statement if neither Transferor, Acquiring, nor any of their shareholders would be required to file the statement at the time of the transaction but at some later time either Transferor or Acquiring becomes a person required to file a

U.S. return or a CFC, or the stock or loss duplication property is acquired by such a person or a CFC in a transferred basis transaction. For this purpose, the final regulations expand the proposed rule to treat CFPs in the same manner as CFCs.

The final regulations expand the proposed rules in two respects. First, the final regulations provide that, if a person holds property received in a transaction with a basis determined directly or indirectly by reference to the basis of loss duplication property or stock received in a loss duplication transaction, the filing requirements will treat such person as Transferor or Acquiring (as applicable) for purposes of determining who must file a Section 362(e)(2)(C) Statement and when.

Second, the final regulations provide that a Section 362(e)(2)(C) Statement must be filed with a U.S. return (or U.S. returns) for the first taxable year in which property with a basis determined by reference to the basis of loss duplication property or stock received in a loss duplication transaction is acquired by a person required to file a U.S. return, a CFC, or a CFP. If, in the same taxable year, more than one person has an event that causes such basis to become relevant for U.S. tax purposes, the Section 362(e)(2)(C) Statement must be filed by all such persons with their U.S. return for that first year.

These two changes were determined necessary to prevent transactions from qualifying for the two-year exception for transactions outside the U.S. tax system if the basis of property exchanged in a transaction becomes relevant for U.S. tax purposes within two years of the transaction, as it would not be unduly burdensome to require the valuation necessary to comply with section 362(e)(2) in such a case.

These rules are expected to have limited application, inasmuch as they will generally only apply if, within two years of the transaction, a party to the transaction becomes a person required to file a U.S. return, a CFC, or a CFP, or such a person acquires the loss duplication property or stock received in a loss duplication transaction in a transferred basis transaction. These rules will also apply in the limited situations in which Transferor is a U.S. person not otherwise required to file a U.S. return and Acquiring is neither required to file a U.S. return, a CFC, nor a CFP (such a case would not qualify for the two-year exception for transactions outside the U.S. tax system because a U.S. person is a party to the transaction).

7. Transactions Involving Partnerships and S Corporations

Like the proposed regulations, the final regulations expressly confirm that any reduction to a transferor's basis in Acquiring stock by reason of a section 362(e)(2)(C) election is an expenditure or expense under section 705(a)(2)(B) (if Transferor is a partnership) and under section 1367(a)(2)(D) (if Transferor is an S corporation). However, in response to questions raised with regard to the proposed regulations, the final regulations provide further guidance on the interaction between section 362(e)(2) and both subchapter K and subchapter S. Specifically, the final regulations clarify that no stock basis reduction is required under section 1367(a)(2)(D) by reason of a reduction to the S corporation's basis in acquired assets if a section 362(e)(2)(C) election is not made. In addition, the final regulations include examples illustrating the consequences of transfers to and by S corporations, as well as transfers by partnerships. For example, practitioners raised concerns that S corporation shareholders electing to reduce the basis of their S corporation stock under section

362(e)(2)(C) may inadvertently eliminate their loss completely when the transferred asset is sold. The IRS and Treasury Department recognize that the elimination of any tax benefit from the economic loss can result in such cases and, to alert taxpayers to the potential elimination of loss, the final regulations include an example to illustrate the application of section 362(e)(2) to transfers made both with and without the election under section 362(e)(2)(C). See Example 9 in paragraph (h) of the final regulations §1.362-4.

8. Examples

The final regulations include revised and expanded examples based on those in the proposed regulations. For example, in response to questions about the scope of the application of section 362(e)(2) to reorganizations, the final regulations include not only examples from the proposed regulations illustrating the application of section 362(e)(2) to transactions qualifying as both section 351 transactions and reorganizations, they also include an example illustrating the nonapplicability of section 362(e)(2) to triangular reorganizations that do not include a transfer to which section 362(a) applies.

9. Other Requests for Comments in the Proposed Regulations

Although the preamble to the proposed regulations invited comments concerning whether special rules were needed to address the interaction of section 362(e)(2) and section 336(d) when a section 362(e)(2)(C) election is made, and whether the regulations should deem a section 362(e)(2)(C) election in the case of a section 304 transaction, no comments were received regarding these issues. Accordingly, no special rules addressing these issues are included in the final regulations.

10. Effective/applicability date

These final regulations generally adopt the proposed effective date and thus are applicable to transactions occurring after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, the final regulations modify the proposed effective date to provide that the final regulations do not apply to transactions after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, that were effected pursuant to a binding agreement that was in effect prior to **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, and at all times thereafter. In addition, the final regulations provide that taxpayers may apply these rules to any transaction occurring after October 22, 2004.

11. Revision of §602.101, Table of OMB Control Numbers

This Treasury Decision revises §602.101 of this chapter (OMB Control Numbers under Paperwork Reduction Act) to include the OMB control number 1545-2247 issued with respect to the collection of information in this Treasury Decision, as well as OMB control number 1545-2125 issued with respect to the collections of information in §§1.336-2 and 1.336-4 (TD 9619, 78 FR 28467) May 15, 2013.

Effect on Other Documents

The following publication is obsolete as of **[INSERT DATE THAT THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**:

Notice 2005-70 (2005-2 CB 694).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Further, it is hereby

certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the collection of information in these regulations merely provides a mechanism whereby, once a transferor and transferee have agreed that it would be advantageous to elect the special basis treatment afforded under section 362(e)(2)(C), the transferor (or in limited cases the transferee) can report the existence of the agreement, and minimal identifying information regarding the transaction and the parties, on its return in order to make the election effective. The minimal identifying information should be readily available to the parties and the professional skills that would be necessary to make the election would be the same as those required to prepare a return for the small business. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, these final regulations, as well as the proposed regulations preceding these final regulations, were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal author of these regulations is Jean R. Broderick of the Office of Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry for § 1.362-4 to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.362-4 also issued under 26 U.S.C. 362(e)(2)(C)(ii). * * *

Par. 2. Section 1.358-2 is amended by revising paragraph (a)(2)(viii) and adding a new sentence at the end of paragraph (d) to read as follows:

§1.358-2 Allocation of basis among nonrecognition property.

(a) * * *

(2) * * *

(viii) This paragraph (a)(2) shall not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and either section 354 or 356, if, in connection with the exchange--

(A) The shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor section 356 applies;

(B) The shareholder or security holder exchanges property for stock or securities in a transaction for which an election to apply section 362(e)(2)(C) is in effect; or

(C) Liabilities of the shareholder or security holder are assumed.

* * * * *

(d) Effective/applicability date. * * * However, paragraph (a)(2)(viii) of this section applies only to exchanges and distributions of stock occurring on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**; taxpayers may also apply paragraph (a)(2)(viii) of this section to transactions occurring after October 22, 2004.

Par. 3. Section 1.362-4 is amended by revising the section heading and paragraph (a)(1), and adding paragraphs (b) through (j) to read as follows:

§1.362-4 Basis of loss duplication property.

(a) Purpose and scope--(1) In general. The purpose of section 362(e)(2) and this section is to prevent the duplication of net loss in transfers to which section 351 applies, capital contributions, and paid-in surplus (each, a section 362(a) transaction). See paragraph (g) of this section for definitions of terms used in this section.

(2) * * *

(b) Basis determinations under section 362(e)(2) and this section.

Notwithstanding section 362(a), if a corporation (Acquiring) receives loss duplication property (as defined in paragraph (g)(1) of this section) from a person (Transferor) in a loss duplication transaction (as defined in paragraph (g)(2) of this section), Acquiring's basis in such property is equal to the basis of the property determined without regard to section 362(e)(2) and this section (as described in paragraph (g)(1)(ii) of this section), reduced by the property's allocable portion of Transferor's net built-in loss (as defined in paragraph (g)(3) of this section). If more than one Transferor transfers property to a corporation in a section 362(a) transaction, whether and the extent to which section 362(e)(2) and this section apply is determined separately for each Transferor.

(c) Exceptions--(1) Transactions in which net built-in loss is eliminated without recognition. Section 362(e)(2) does not apply to a transaction to the extent that--

(i) Without recognizing gain or loss, Transferor distributes the Acquiring stock received in the transaction; and

(ii) Upon completion of the transaction, no person holds Acquiring stock or any other asset with a basis determined, in whole or in part, by reference to Transferor's basis in the distributed Acquiring stock.

(2) Certain transactions outside of the United States. Section 362(e)(2) does not apply to a transaction if--

(i) Neither Transferor nor Acquiring is a U.S. person (as defined in section 7701(a)(30)), a person otherwise required to file a U.S. return for the year of the transaction, a controlled foreign corporation (CFC, as defined in paragraph (g)(7) of this section), or a controlled foreign partnership (CFP, as defined in paragraph (g)(9) of this section) on the date of the transaction;

(ii) The transfer occurs more than two years prior to the date of any event described in paragraph (d)(3)(ii)(E), (F), or (G) of this section; and

(iii) The original transaction and the event or events described in paragraph (d)(3)(ii)(E), (F), or (G) of this section were not entered into with a view to reducing or avoiding the Federal income tax liability of any person by avoiding the application of section 362(e)(2) and this section to the original transaction.

(d) Election to reduce Transferor's stock basis instead of Acquiring's asset basis--(1) In general. In lieu of making the basis reductions otherwise required under paragraph (b) of this section, Transferor and Acquiring may elect to reduce Transferor's

basis in Acquiring stock that is received in the transaction without the recognition of gain or loss (the section 362(e)(2)(C) election). The section 362(e)(2)(C) election may be made protectively and will have no effect to the extent that property transferred in the transaction is determined not to be subject to section 362(e)(2) and this section. However, the election is irrevocable once it is made. A section 362(e)(2)(C) election is made and effective if--

(i) Prior to the filing of a Section 362(e)(2)(C) Statement (described in paragraph (d)(3)(i) of this section), Transferor and Acquiring enter into a written, binding agreement to elect to apply section 362(e)(2)(C); and

(ii) The Section 362(e)(2)(C) Statement is filed in accordance with the provisions of paragraph (d)(3) of this section.

(2) Effect of section 362(e)(2)(C) election. If a section 362(e)(2)(C) election is made and in effect--

(i) An amount equal to the portion of Transferor's net built-in loss (as defined in paragraph (g)(3) of this section) that would otherwise be applied to reduce asset basis under paragraph (b) of this section is allocated among the Acquiring shares received or deemed received in the exchange (in proportion to the value of such shares) and applied to reduce Transferor's basis (determined without regard to section 362(e)(2) and this section) in each such share; and

(ii) Acquiring's basis in loss duplication property received from Transferor in the transaction is not determined under section 362(e)(2) and this section.

(3) Section 362(e)(2)(C) Statement--(i) Form and contents of statement. The Section 362(e)(2)(C) Statement is to be titled "Section 362(e)(2)(C) Statement." The Section 362(e)(2)(C) Statement must--

(A) Identify (by name and tax identification number, if any) Transferor and Acquiring;

(B) State that Transferor and Acquiring have entered into a written, binding agreement to elect to apply section 362(e)(2)(C) as required in paragraph (d)(1)(i) of this section; and

(C) State the date of the transaction (or, if the transaction includes transfers on more than one date, then the dates of all transfers) to which the election applies.

(ii) Filing the Section 362(e)(2)(C) Statement. In general, the Section 362(e)(2)(C) Statement is filed by the person or entity described in the applicable paragraph of this paragraph (d)(3)(ii). Thus, if Transferor is a partnership, S corporation, trust (including a subpart E trust), or other pass-through entity, or Acquiring is an S corporation, the entity (and not the partners, shareholders, or other persons having an interest in the entity or its property) is the person that must file the Section 362(e)(2)(C) Statement, without regard to whether such entity is foreign or domestic. However, in the case of a CFC or CFP, the controlling U.S. shareholders of the CFC or the reporting U.S. partners of the CFP, respectively, file the Section 362(e)(2)(C) Statement.

(A) Transferor is a person required to file a U.S. return. If Transferor is a person required to file a U.S. return for the year of the transfer, Transferor must include the

Section 362(e)(2)(C) Statement on or with its timely filed (including extensions) original U.S. return for the taxable year in which the transfer occurred.

(B) Transferor is a CFC or CFP and not required to file a U.S. return. If paragraph (d)(3)(ii)(A) of this section does not apply and Transferor is either a CFC or a CFP on the date of the transfer, all of Transferor's controlling U.S. shareholders (in the case of a CFC) or all of Transferor's reporting U.S. partners (in the case of a CFP) must include the Section 362(e)(2)(C) Statement on or with their timely filed (including extensions) original U.S. returns for their taxable years in which the transfer occurred.

(C) Transferor is not a person required to file a U.S. return, a CFC, or a CFP, but Acquiring is required to file U.S. return. If paragraphs (d)(3)(ii)(A) and (B) of this section do not apply and Acquiring is a person required to file a U.S. return for the year of the transfer, Acquiring must include the Section 362(e)(2)(C) Statement on or with its timely filed (including extensions) original U.S. return for the taxable year in which the transfer occurred.

(D) Transferor is not a person required to file a U.S. return, a CFC, or a CFP, Acquiring is not required to file a U.S. return, but Acquiring is a CFC. If paragraphs (d)(3)(ii)(A) through (C) of this section do not apply and Acquiring is a CFC on the date of the transfer, all of Acquiring's controlling U.S. shareholders must include the Section 362(e)(2)(C) Statement on or with their timely filed (including extensions) original U.S. returns for their taxable years in which the transfer occurred.

(E) Neither Transferor nor Acquiring is a person required to file a U.S. return, a CFC, or a CFP, but Transferor later becomes a person required to file a U.S. return, a CFC, or a CFP. If paragraphs (d)(3)(ii)(A) through (D) of this section do not apply and

Transferor becomes a person required to file a U.S. return, a CFC, or a CFP, Transferor (if required to file a U.S. return), all of Transferor's controlling U.S. shareholders (if Transferor becomes a CFC not otherwise required to file a U.S. return), or all of Transferor's reporting U.S. partners (if Transferor becomes a CFP not otherwise required to file a U.S. return) must include the Section 362(e)(2)(C) Statement on or with their timely filed (including extensions) original U.S. returns for their taxable years in which an event described in this paragraph (d)(3)(ii)(E) first occurs. For purposes of this paragraph (d)(3)(ii)(E), the term Transferor includes any person holding property with a basis determined directly or indirectly by reference to Transferor's basis in the Acquiring stock received in the transaction.

(F) Transferor is not and does not become a person required to file a U.S. return, a CFC, or a CFP, Acquiring is not, but later becomes either a person required to file a U.S. return, a CFC, or a CFP. If paragraphs (d)(3)(ii)(A) through (E) of this section do not apply and Acquiring becomes a person required to file a U.S. return, a CFC, or a CFP, Acquiring (if required to file a U.S. return), all of Acquiring's controlling U.S. shareholders (if Acquiring becomes a CFC not otherwise required to file a U.S. return), or all of Acquiring's reporting U.S. partners (if Acquiring becomes a CFP not otherwise required to file a U.S. return) must include the Section 362(e)(2)(C) Statement on or with their timely filed (including extensions) original U.S. returns for their taxable years in which an event described in this paragraph (d)(3)(ii)(F) first occurs. For purposes of this paragraph (d)(3)(ii)(F), the term Acquiring includes any person holding property with a basis determined directly or indirectly by reference to Acquiring's basis in loss duplication property received in the transaction.

(G) Transferor and Acquiring are not and do not become a person required to file a U.S. return, a CFC, or a CFP, but the basis of the loss duplication property or Acquiring stock later becomes relevant for Federal tax purposes. If paragraphs (d)(3)(ii)(A) through (F) of this section do not apply and, in a transferred basis transaction, a person required to file a U.S. return, a CFC, or a CFP acquires either loss duplication property or Acquiring stock that was received in the loss duplication transaction, or any property the basis of which is determined in whole or in part by reference to any such property or stock, all such persons (or, in the case of a CFC or CFP not required to file a U.S. return, all the controlling U.S. shareholders or all the reporting U.S. partners, as applicable) must include the Section 362(e)(2)(C) Statement on or with their timely filed (including extensions) original U.S. returns for their first taxable year(s) in which there occurs an event or events described in this paragraph (d)(3)(ii)(G).

(e) Transfers by partnerships and S corporations--(1) Transfers by partnerships. If a partnership transfers property in a loss duplication transaction with respect to which a section 362(e)(2)(C) election is made, the resulting reduction to the partnership's basis in the Acquiring stock received in exchange for the loss duplication property is treated as an expenditure of the partnership described in section 705(a)(2)(B).

(2) Transfers by S corporations. If an S corporation transfers property in a loss duplication transaction with respect to which a section 362(e)(2)(C) election is made, the resulting reduction to the S corporation's basis in the Acquiring stock received in exchange for the loss duplication property is treated as an expense of the S corporation described in section 1367(a)(2)(D).

(f) Transfers to S corporations. If a person transfers property to an S corporation in a loss duplication transaction, any resulting reduction under section 362(e)(2) and this section to the S corporation's basis in the property received is not treated as an expense of the S corporation described in section 1367(a)(2)(D).

(g) Definitions. For purposes of section 362(e)(2) and this section--

(1) Loss duplication property is any property--

(i) That is transferred by Transferor to Acquiring in a loss duplication transaction (as defined in paragraph (g)(2) of this section); and

(ii) That Acquiring would take with a basis in excess of value immediately after the transaction; for this purpose, the basis Acquiring would take in the property is determined immediately after the transaction and without regard to section 362(e)(2) and this section, but otherwise taking into account all applicable provisions of law, including, without limitation, section 362(e)(1).

(2) A loss duplication transaction is a section 362(a) transaction in which Acquiring's aggregate basis in the property received from Transferor would, but for section 362(e)(2) and this section, exceed the aggregate value of such property immediately after the transaction. For this purpose--

(i) A transaction is a section 362(a) transaction if it is described in section 362(a) without regard to whether it is also described in any other provision of the Internal Revenue Code (Code), including, without limitation, section 362(b); and

(ii) Acquiring's aggregate basis in the property received from Transferor is determined immediately after the transaction and without regard to section 362(e)(2)

and this section, but otherwise taking into account all applicable provisions of law, including, without limitation, section 362(e)(1).

(3) Transferor's net built-in loss is the excess of--

(i) Acquiring's aggregate basis (determined under paragraph (g)(2)(ii) of this section) in all property received from Transferor in a loss duplication transaction, over

(ii) The aggregate value of such property immediately after the transaction.

(4) A property's built-in loss is the excess of Acquiring's basis in the property (determined as described in paragraph (g)(1)(ii) of this section) over the property's value (determined immediately after the transaction).

(5) A property's allocable portion of Transferor's net built-in loss is the portion of Transferor's net built-in loss that bears the same ratio to Transferor's net built-in loss that the property's built-in loss bears to the aggregate built-in losses reflected in the bases of loss duplication property transferred by Transferor in the transaction.

(6) A U.S. return is a return of income under section 6012 or an information return under Subtitle F, Chapter 61, Subchapter A, Part III of the Code (sections 6031 and following) or the regulations thereunder, that the taxpayer is unconditionally required to file. Thus, the term does not include elective forms or statements that are required to be filed only to obtain a particular tax treatment, including forms filed to make an election or to reduce or avoid withholding by a person not otherwise required to file a U.S. return (as described in this paragraph (g)(6)) (for example, a notice of nonrecognition under §1.1445-2(d)).

(7) A controlled foreign corporation (CFC) is any corporation described in section 957 or section 953(c).

(8) A controlling U.S. shareholder is any person that is treated as a controlling U.S. shareholder under §1.964-1(c)(5) because such person either owns a direct interest in the CFC or is treated as owning an interest in the CFC by reason of section 318(a)(2) (attribution from partnerships, estates, trusts, and corporations).

(9) A controlled foreign partnership (CFP) is any partnership treated as a controlled foreign partnership for purposes of section 6038.

(10) A reporting U.S. partner is any partner of a CFP that is required to file an information return with respect to the CFP pursuant to section 6038 or the regulations thereunder, without regard to §1.6038-3(c) or (j). In addition, in applying the constructive ownership rules of § 1.6038-3(b)(4), the term “nonresident alien” is replaced by the term “individual.”

(11) The term stock means both Acquiring stock and Acquiring securities received by Transferor in the transaction if gain or loss on the receipt of the stock or securities is not recognized in whole or in part.

(12) Value. (i) General rule. The term value means fair market value.

(ii) Special rule for transfers of partnership interests. Notwithstanding the general rule in paragraph (g)(12)(i) of this section, when referring to a partnership interest, for purposes of section 362(e)(2) and this section, the term value means the sum of the cash that Acquiring would receive for the interest, assuming an exchange between a willing buyer and a willing seller (neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts), increased by any §1.752-1 liabilities (as defined in §1.752-1(a)(4)) of the partnership allocated to Acquiring with regard to such transferred interest under section 752 immediately after

the transfer to Acquiring. See §1.743-1 regarding the application of section 743(b) following a section 362(e) basis reduction.

(h) Examples. The examples in this paragraph (h) illustrate the application of section 362(e)(2) and this section. For purposes of these examples, X, Y, P, S, S1, S2, and DC are domestic corporations; A and B are U.S. individuals; FC1 and FC2 are foreign corporations and, unless otherwise indicated, are not required to file a U.S. return and are not CFCs; and PRS is a domestic partnership. Unless the facts indicate otherwise, all persons and transactions are unrelated; Acquiring's basis in the transferred property is not determined under section 362(e)(1); the property transferred is not described in section 362(e)(1)(B); no election is made under section 362(e)(2)(C), and the transactions are not subject to recharacterization.

Example 1. Transfer described in section 351. (i) Basic application of section. (A) Facts. A owns Asset 1 (basis \$90, value \$60) and Asset 2 (basis \$110, value \$120). In a transaction to which section 351 applies, A transfers Asset 1 and Asset 2 to X in exchange for a single outstanding share of X stock representing all the outstanding X stock immediately after the transaction.

(B) Analysis. (1) Loss duplication transaction. A's transfer of Asset 1 and Asset 2 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's aggregate basis in those assets would be \$200 (\$90 + \$110), which would exceed the aggregate value of the assets \$180 (\$60 + \$120) immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and A has a net built-in loss of \$20 (\$200 - \$180).

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$90, which would exceed Asset 1's \$60 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 2 would be \$110, which would not exceed Asset 2's \$120 value immediately after the transaction. Accordingly, Asset 2 is not loss duplication property.

(C) Basis in loss duplication property. X's basis in Asset 1 is \$70, computed as its \$90 basis under section 362(a) reduced by A's \$20 net built-in loss.

(D) Basis in other property. Under section 362(a), X has a transferred basis of \$110 in Asset 2. Under section 358(a), A has an exchanged basis of \$200 in the X stock it receives in the transaction.

(ii) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A) of this Example 1, except that A and X make an election under section 362(e)(2)(C). Under paragraph (d)(2)(i) of this section, A reduces its basis in the X stock, as determined without regard to section 362(e)(2) and this section, by the amount of A's net built-in loss that would have been applied to reduce X's basis in Asset 1 had the section 362(e)(2)(C) election not been made. In addition, no reduction is made to X's basis in Asset 1, as determined without regard to section 362(e)(2) and this section. As a result, A's basis in the X stock is \$180 (\$200 - \$20), X's basis in Asset 1 is \$90, and X's basis in Asset 2 is \$110.

Example 2. Transfer described in both section 351 and section 368(a)(1)(B). (i) Basic application of section. (A) Facts. P owns the sole outstanding share of S1 stock and the ten outstanding shares of S2 stock. In a transaction to which section 351 applies and that is described in section 368(a)(1)(B), P transfers its ten S2 shares to S1 in exchange for an additional ten shares of S1 voting stock. At the time of the transfer, P has a basis of \$10 each in five of its S2 shares (Shares 1 – 5) and a basis of \$5 each in its other five S2 shares (Shares 6 – 10), and the value of each share is \$7.

(B) Analysis. (1) Loss duplication transaction. P's transfer of the S2 shares is a section 362(a) transaction notwithstanding that it is also a transaction described in section 368(a)(1)(B) and therefore section 362(b). But for section 362(e)(2) and this section, S1's aggregate basis in the S2 shares would be \$75 (\$10 x 5, or \$50, for Shares 1-5 + \$5 x 5, or \$25, for Shares 6-10). Thus, S1's \$75 aggregate basis in the shares would exceed the aggregate value of the shares, \$70 (\$7 x 10 shares), immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and P has a net built-in loss of \$5 (\$75 - \$70).

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, S1's basis in each of Shares 1-5 would be \$10, which would exceed each share's \$7 value immediately after the transaction. Accordingly, Shares 1-5 are each loss duplication property. But for section 362(e)(2) and this section, S1's basis in each of Shares 6-10 would be \$5, which would not exceed each share's \$7 value immediately after the transaction. Accordingly, Shares 6-10 are not loss duplication property.

(C) Basis in loss duplication property. S1's basis in each of Shares 1 – 5 is \$9, computed as its \$10 basis (determined without regard to section 362(e)(2) and this section) reduced by \$1, the share's allocable portion (1/5) of P's net built-in loss (\$5).

(D) Basis in other property. Under section 362(a), S1 has a transferred basis of \$5 in each of Shares 6 - 10. Under section 358(a), P has an exchanged basis in the ten S1 shares it receives in the exchange (\$10 in each of the five S1 shares received in

exchange for Shares 1-5 and \$5 in each of the five S1 shares received in exchange for Shares 5 – 10).

(ii) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A) of this Example 2, except that an election under section 362(e)(2)(C) is made to reduce P's basis in the shares of S1 stock received in the exchange. Under paragraph (d)(2)(i) of this section, P reduces its basis in the S1 stock by \$5, the amount of P's net built-in loss that S1's basis in the S2 shares would have been reduced under section 362(e)(2) and this section had the section 362(e)(2)(C) election not been made, and no reduction is made to S1's basis in the S2 stock (as determined without regard to section 362(e)(2) and this section). Because an election is being made under section 362(e)(2)(C), P's basis in the new S1 shares is not determined under the general rule of §1.358-2(a)(2)(i) (under which P's basis in each new S1 share would be equal to the basis of the S2 share transferred in exchange for the S1 share). Section 1.358-2(a)(2)(viii)(B). Accordingly, P's basis in each new S1 share will be \$7, the share's allocable portion of P's \$75 aggregate basis in the S2 shares transferred in the transaction (or, \$7.50 per share), reduced under paragraph (d)(2)(i) of this section by the \$5 that would have been applied to reduce S1's basis in the S2 shares had the section 362(e)(2)(C) election not been made (or \$.50 per share). Under paragraph (d)(2)(ii) of this section and section 362(a), S1 receives five shares of the S2 stock with a basis of \$10 each and five shares of the S2 stock with a basis of \$5 each.

Example 3. Transfer described in both section 351 and section 368(a)(1)(A), multiple transferors, elimination of duplicated loss. (i) Facts. A owns Asset 1 (basis \$120, value \$130) and all the outstanding shares of X stock. B owns all the outstanding shares of Y stock (basis \$150). Y owns Asset 2 (basis \$250, value \$210). Pursuant to a single plan, A transfers Asset 1 to X in exchange for additional X shares and, in a transaction qualifying as a reorganization described in section 368(a)(1)(A), Y merges with and into X. In the merger, B receives X stock with a basis equal to B's basis in its Y stock immediately before the merger. A's transfer of Asset 1 to X in exchange for X stock and Y's transfer of Asset 2 to X in the merger are both transactions to which section 351 applies. Notwithstanding that the transfers by A and Y are pursuant to a single plan forming one transaction, section 362(e)(2) and this section apply to each transferor separately.

(ii) Application of section to A's transfer of Asset 1. A's transfer of Asset 1 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$120, which would not exceed Asset 1's \$130 value immediately after the transaction. Accordingly, A's transfer of Asset 1 is not a loss duplication transaction notwithstanding that, taking both A's transfer and Y's transfer into account, X has an aggregate net loss in Asset 1 and Asset 2. Because Asset 1 is not received in a loss duplication transaction, it is not loss duplication property and section 362(e)(2) and this section do not apply to A's transfer of Asset 1.

(iii) Application of section to Y's transfer of Asset 2. (A) Analysis. (1) Loss duplication transaction. Y's transfer of Asset 2 to X is a section 362(a) transaction,

notwithstanding that it is also a transaction described in section 368(a)(1)(A) and therefore section 362(b). But for section 362(e)(2) and this section, X's basis in Asset 2 would be \$250, which would exceed Asset 2's \$210 value immediately after the transaction. Accordingly, Y's transfer is a loss duplication transaction and Y has a net built-in loss of \$40.

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 2 would be \$250, which would exceed Asset 2's \$210 value immediately after the transaction. Accordingly, Asset 2 is loss duplication property.

(B) Basis in loss duplication property. Although Asset 2 is loss duplication property, section 362(e)(2) does not apply to Y's transfer of Asset 2 to X because Y distributes all of the X stock received in the exchange without recognizing gain or loss, and, upon completion of the transaction, no person will hold the X stock or any other asset with a basis determined in whole or in part by reference to Y's basis in such stock. Accordingly, under paragraph (c)(1) of this section, X's basis in Asset 2 is not determined under section 362(e)(2) and this section. Thus, under section 362(a), X's basis in Asset 2 is \$250.

(iv) Basis in other property. Under section 358, A's basis in the X stock received in exchange for Asset 1 is \$120 and B's basis in the X stock received in the merger is \$150. Under section 362(a), X's basis in Asset 1 is \$120.

Example 4. Transfer described in both section 351 and section 368(a)(1)(D), followed by a distribution qualifying under section 355. (i) Basic transaction. (A) Facts. A and B each own one of the two outstanding shares of X common stock. X's assets include Asset 1 (basis \$120, value \$70), Asset 2 (basis \$160, value \$110), and Asset 3 (basis \$220, value \$240). In a transaction to which section 351 applies and that is described in section 368(a)(1)(D), X transfers Asset 1, Asset 2, and Asset 3 to Y in exchange for all the Y stock; then, in a distribution that qualifies under section 355, X distributes all the Y stock received in the exchange to A in exchange for all of A's X stock. Under section 361(c)(1), X does not recognize gain or loss as a result of the distribution of all the Y stock.

(B) Analysis. (1) Loss duplication transaction. X's transfer of Asset 1, Asset 2, and Asset 3 is a section 362(a) transaction. But for section 362(e)(2) and this section, Y's aggregate basis in those assets would be \$500 (\$120 + \$160 + \$220). The aggregate value of the assets immediately after the transaction is \$420 (\$70 + \$110 + \$240). Thus, Y's aggregate basis in the assets would exceed the aggregate value of the assets immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and X has a net built-in loss of \$80 (\$500 - \$420).

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, Y's basis in Asset 1 would be \$120, which would exceed Asset 1's \$70 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, Y's basis in Asset 2 would be \$160, which would

exceed Asset 2's \$110 value immediately after the transaction. Accordingly, Asset 2 is also loss duplication property. But for section 362(e)(2) and this section, Y's basis in Asset 3 would be \$220 and would therefore not exceed Asset 3's \$240 value immediately after the transaction. Accordingly, Asset 3 is not loss duplication property.

(C) Basis in loss duplication property. Although Asset 1 and Asset 2 are each loss duplication property, X will distribute the Y stock received in exchange for Asset 1 and Asset 2 without recognition of gain or loss, and, upon completion of the transaction, no person will hold the Y stock received by X or any other asset with a basis determined in whole or in part by reference to X's basis in the Y stock received in the exchange. (A's basis in the Y stock will be determined by reference to his basis in his X stock.) Accordingly, under paragraph (c)(1) of this section, Y's bases in Asset 1 and Asset 2 are determined under section 362(a) and not under section 362(e)(2) and this section. Thus, Y's basis in Asset 1 is \$120 and Y's basis in Asset 2 is \$160.

(D) Basis in other property. Under section 358, A's basis in the Y stock received in exchange for his X stock is determined by reference to his basis in his X stock surrendered. Under section 362(a), Y's basis in Asset 3 is \$220.

(ii) Section 355(e). (A) Facts. The facts are the same as in paragraph (i)(A) of this Example 4, except that, after the section 355 distribution, Y is acquired pursuant to a plan (within the meaning of §1.355-7), resulting in the application of section 355(e) to the transactions.

(B) Analysis. Because section 361(c)(2), and not section 361(c)(1), will apply to X's distribution of Y stock, X will not qualify for nonrecognition treatment on the distribution of the Y stock. As a result, paragraph (c)(1) of this section does not apply to the transaction, and Y's bases in Asset 1 and Asset 2, the loss duplication property, are determined under section 362(e)(2) and this section. Asset 1 has a built-in loss of \$50 (\$120 - \$70), and Asset 2 has a built-in loss of \$50 (\$160 - \$110). Thus, Asset 1's allocable portion of X's net built-in loss is \$40 (\$50/\$100 x \$80), and Asset 2's allocable portion of X's net built-in loss is \$40 (\$50/\$100 x \$80). Accordingly, Y receives Asset 1 with a basis of \$80 (\$120 - \$40) and Asset 2 with a basis of \$120 (\$160 - \$40).

(iii) Retained stock and securities. (A) Facts. The facts are the same as in paragraph (i)(A) of this Example 4, except that X transfers Asset 1, Asset 2, and Asset 3 to Y in exchange for Y stock and Y securities, each constituting half of the consideration. In addition, for a valid business purpose, X retains Y stock and Y securities each worth 1 percent of the total consideration.

(B) Analysis. Paragraph (c)(1) of this section applies only to the extent that stock received in a transaction is distributed without recognition of gain or loss. Thus, section 362(e)(2) and this section apply to the extent that property was exchanged for the retained Y stock and Y securities (2 percent of the total). Accordingly, Y reduces its basis in Asset 1 and in Asset 2, the loss duplication property, by \$1.60 (two percent of X's \$80 net built-in loss). Asset 1 has a built-in loss of \$50 (\$120 - \$70), and Asset 2

has a built-in loss of \$50 (\$160 - \$110). Thus, Asset 1's allocable portion of X's net built-in loss is \$.80 (\$50/\$100 x \$1.60), and Asset 2's allocable portion of X's net built-in loss is \$.80 (\$50/\$100 x \$1.60). As a result, Y receives Asset 1 with a basis of \$119.20 (\$120 - \$.80) and Asset 2 with a basis of \$159.20 (\$160 - \$.80).

(iv) Retained stock and securities with a section 362(e)(2)(C) election. (A) Facts. The facts are the same as in paragraph (iii)(A) of this Example 4, except that an election under section 362(e)(2)(C) is made to reduce X's bases in its retained Y stock and retained Y securities.

(B) Analysis. Under paragraph (d)(2)(i) of this section, X reduces its basis in the retained Y stock and the retained Y securities (determined without regard to section 362(e)(2) and this section) by \$1.60, the portion of X's \$80 net built-in loss that would have been applied to reduce Y's basis in the transferred assets had the election to apply section 362(e)(2)(C) not been made. (Because the value of the Y stock and the value of the Y securities are equal, X's \$500 basis in the transferred property would be allocated equally between the Y stock and the Y securities, \$250 to each, under §1.358-2(b)(2), and the retained Y stock and Y securities have a basis of \$2.50 each (one percent of \$250).) For the reasons set forth in paragraph (ii)(B) of this Example 4, Y would have been required to reduce its basis in the transferred assets by \$1.60. Accordingly, X must reduce its aggregate basis in the retained Y stock and Y securities by \$1.60. Under paragraph (d)(2)(i) of this section, the \$1.60 basis reduction is allocated and applied to reduce X's bases in the retained Y stock and Y securities in proportion to the value of each. Because X retained Y stock and Y securities with equal values, X holds each of the retained Y stock and securities with an adjusted basis of \$1.70 (\$2.50 - \$.80). Under paragraph (d)(2)(ii) of this section, Y receives Asset 1 with a basis of \$120, Asset 2 with a basis of \$160, and Asset 3 with a basis of \$220.

Example 5. Transfer of liabilities. (i) Liabilities described in section 358(d)(1). (A) Basic application of section, no section 362(e)(2)(C) election. (1) Facts. A owns Asset 1 (basis \$800, value \$700). A also has a \$200 liability that has been taken into account for tax purposes and is thus described in section 358(d)(1), and not in sections 357(c)(3), 358(d)(2), and 358(h)(1). A transfers Asset 1 to X in exchange for a single outstanding share of X stock representing all the outstanding X stock immediately after the transaction and X's assumption of the liability. The transfer is a transaction to which section 351 applies.

(2) Analysis. (i) Loss duplication transaction. A's transfer of Asset 1 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$800, which would exceed Asset 1's \$700 value immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and A has a net built-in loss of \$100 (\$800 - \$700).

(ii) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$800, which would exceed the \$700 value of

Asset 1 immediately after the transaction. Accordingly, Asset 1 is loss duplication property.

(3) Basis in loss duplication property. X's basis in Asset 1 is \$700, computed as its \$800 basis determined under section 362(a) reduced by A's \$100 net built-in loss.

(4) Basis in other property. Under sections 358(a) and (d)(1), A's basis in the X stock is \$600 (\$800 basis in property transferred - \$200 liability assumed).

(B) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A)(1) of this Example 5, except that A and X make an election under section 362(e)(2)(C). In this case, A's \$100 net built-in loss that would have been applied to reduce X's basis in Asset 1 is applied to reduce A's basis in the X stock received. As a result, A's basis in the X stock is \$500 (\$600, as determined in paragraph (i)(A)(4) of this Example 5, reduced by \$100) and X's basis in Asset 1 is \$800.

(ii) Contingent liabilities described in section 358(h)(1), section 358(h)(2)(A) exception applies. (A) Facts. The facts are the same as in paragraph (i)(A)(1) of this Example 5, except that A's liability (valued at \$200) has not been taken into account for tax purposes and is described in sections 358(d)(2) and 358(h)(1). However, Asset 1 is a trade or business and the liability is associated with the trade or business; as a result, the liability is described in section 358(h)(2)(A) and is excepted from the general rule of section 358(h)(1).

(B) Analysis. For the reasons set forth in paragraph (i)(A)(2) of this Example 5, A's transfer of Asset 1 is a loss duplication transaction, A has a net built-in loss of \$100, and Asset 1 is loss duplication property.

(C) Basis in loss duplication property. For the reasons set forth in paragraph (i)(A)(3) of this Example 5, X's basis in Asset 1 is \$700.

(D) Basis in other property. A's basis in the X stock is \$800 under sections 358(a), 358(d)(2), and 358(h)(2)(A).

(E) Section 362(e)(2)(C) election. The facts are the same as in paragraph (ii)(A) of this Example 5, except that A and X make an election under section 362(e)(2)(C). In this case, A's \$100 net built-in loss that would have applied to reduce X's basis in Asset 1 is applied to reduce A's basis in the X stock received. As a result, A's basis in the X stock is \$700 (\$800, as determined in paragraph (ii)(D) of this Example 5, reduced by \$100). X's basis in Asset 1 is \$800.

Example 6. Section 351 transfer with boot. (i) Basic transaction. (A) Facts. A owns Asset 1 (basis \$80, value \$100) and Asset 2 (basis \$30, value \$25). In a transaction to which section 351 applies, A transfers Asset 1 and Asset 2 to X in exchange for 10 shares of X stock and \$25.

(B) Analysis. (1) Loss duplication transaction. A's transfer of Asset 1 and Asset 2 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's aggregate basis in those assets would be \$130, computed as follows. Under section 362(a), a corporation's basis in property acquired in a transaction to which section 351 applies is the same as the property's basis in the hands of the transferor, increased by any gain recognized to the transferor on such transfer. Under section 351(b), gain (but not loss) is recognized to the extent a transferor in a section 351 exchange receives other property or money in addition to the stock permitted to be received without the recognition of gain. To determine the amount of gain recognized under section 351(b), the consideration is allocated proportionately (by value) among the transferred properties. A's gain on the transfer is therefore computed as follows: Asset 1 reflects 80 percent of the value transferred ($\$100/\125) and Asset 2 reflects 20 percent of the value transferred ($\$25/\125). Thus, 80 percent of the stock (eight shares) and the cash (\$20) are treated as being received in exchange for Asset 1 and 20 percent of the stock (two shares) and the cash (\$5) are treated as being received in exchange for Asset 2. Thus, under section 351(b), A recognizes \$20 of gain for the cash received in exchange for Asset 1, but A recognizes no loss for the amount received for Asset 2. As a result, under section 362(a), X would have a basis of \$100 in Asset 1 and \$30 in Asset 2. Thus, X's aggregate basis in the assets would be \$130, which exceeds the \$125 aggregate value of the assets ($\$100 + \25). The transfer is a loss duplication transaction and A has a net built-in loss of \$5 ($\$130 - \125).

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$100 (A's \$80 basis increased by A's \$20 gain recognized), which would not exceed Asset 1's \$100 value immediately after the transaction. Accordingly, Asset 1 is not loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 2 would be \$30, which would exceed Asset 2's \$25 value immediately after the transaction. Accordingly, Asset 2 is loss duplication property.

(C) Basis in loss duplication property. X's basis in Asset 2 is \$25, computed as its \$30 basis under section 362(a) reduced by A's \$5 net built-in loss.

(D) Basis in other property. Under section 362(a), X's basis in Asset 1 is \$100 (A's \$80 basis increased by the \$20 gain recognized). Under section 358, A's basis in the X stock is \$105 (the sum of its \$80 basis in Asset 1, its \$30 basis in Asset 2, and its \$20 gain recognized, reduced by the \$25 cash received in the exchange).

(ii) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A) of this Example 6, except that A and X elect to reduce A's stock basis under section 362(e)(2)(C). Under paragraph (d)(2)(i) of this section, A reduces its \$105 basis in the X stock by \$5, the amount of A's net built-in loss of that would have been applied to reduce X's basis in Asset 2 had the section 362(e)(2)(C) election not been made. As a result, A's basis in the X stock is \$100, and X's basis in Asset 2 is \$30.

Example 7. Section 304 sale of built-in loss stock. (i) Basic transaction. (A) Facts. A owns all the stock of X (basis \$90, value \$60) and all the stock of Y. A sells all his X stock to Y for \$60. Under section 304, A is treated as though he transferred the X stock to Y in exchange for Y stock in a transaction to which section 351 applies. Then, Y is treated as redeeming the Y stock it was treated as having issued to A in the deemed section 351 transaction.

(B) Analysis. (1) Loss duplication transaction. A's deemed transfer of X stock to Y is a section 362(a) transaction. But for section 362(e)(2) and this section, Y's aggregate basis in the X stock would be \$90, which would exceed the X stock's value of \$60 immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and A has a net built-in loss of \$30.

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, Y's basis in the X stock would be \$90, which would exceed the X stock's \$60 value immediately after the transaction. Accordingly, the X stock is loss duplication property.

(C) Basis in loss duplication property. Y's basis in the X stock is \$60, its \$90 basis determined without regard to section 362(e)(2) and this section, reduced by A's \$30 net built-in loss.

(D) Basis in other property. Under section 358(a), A has an exchanged basis of \$90 in the Y stock he is deemed to receive in the exchange; the effect of the deemed redemption of that stock is then determined under section 302.

(ii) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A) of this Example 7, except that the parties elect to reduce A's stock basis under section 362(e)(2)(C). For the reasons set forth in paragraphs (i)(B) and (C) of this Example 7, Y's basis in the X stock would be reduced by \$30. Accordingly, A's basis in the deemed-issued Y stock is \$60, his \$90 basis otherwise determined under section 358(a) reduced by the \$30 that would have been applied to reduce Y's basis in the X stock under section 362(e)(2) and this section; the effect of the deemed redemption of that stock is then determined under section 302. Y's basis in the X stock is \$90.

Example 8. Transactions involving partnerships. (i) Transfer by a partnership. (A) Basic application of section. (1) Facts. PRS owns Asset 1 (basis \$100, value \$70). PRS contributes Asset 1 to X in a transaction to which section 351 applies.

(2) Analysis. (i) Loss duplication transaction. PRS's transfer of Asset 1 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$100, which would exceed Asset 1's \$70 value immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and PRS has a net built-in loss of \$30 (\$100 - \$70).

(ii) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$100, which would exceed Asset 1's \$70 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property.

(3) Basis in loss duplication property. X's basis in Asset 1 is \$70, computed as its \$100 basis under section 362(a) reduced by PRS's \$30 net built-in loss.

(4) Basis in other property. Under section 358(a), PRS has an exchanged basis of \$100 in the X stock it receives in the exchange.

(B) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A)(1) of this Example 8, except that PRS and X elect to reduce PRS's stock basis under section 362(e)(2)(C). In this case, PRS's \$30 net built-in loss (as determined in paragraph (i)(A)(2)(i) of this Example 8) that would have been applied to reduce X's basis in Asset 1 is applied to reduce PRS's basis in the X stock received. As a result, PRS's basis in the X stock is \$70 (\$100 - \$30) and X's basis in Asset 1 is \$100. The \$30 reduction to PRS's basis in the X stock is treated as an expenditure of PRS under section 705(a)(2)(B) and paragraph (e)(1) of this section. As a result, the partners of PRS must reduce their bases in their PRS interests.

(ii) Transfer of interest in partnership with liability. (A) Basic application of section. (1) Facts. A and two other individuals are equal partners in PRS. A's basis in its partnership interest is \$247. A's share of PRS's §1.752-1 liabilities (as defined in §1.752-1(a)(4)) is \$145. A transfers his partnership interest to X in a transaction to which section 351 applies. PRS has no election in effect under section 754. If X were to sell the PRS interest immediately after the transfer, X would receive \$100 in cash or other property. In addition, assume that, taking into account the rules under §1.752-4, X's share of PRS's §1.752-1 liabilities (as defined in §1.752-1(a)(4)) is \$150 immediately after the transfer.

(2) Analysis. (i) Loss duplication transaction. A's transfer of its PRS interest is a section 362(a) transaction. But for section 362(e)(2) and this section, X's basis in the PRS interest, would be \$252 (A's basis of \$247, reduced by A's \$145 share of PRS liabilities, increased by X's \$150 share of PRS liabilities) and, under paragraph (g)(12)(ii) of this section, the value of the PRS interest would be \$250 (the sum of \$100, the cash X would receive if X immediately sold the interest, and \$150, X's share of the §1.752-1 liabilities (as defined in §1.752-1(a)(4)) under section 752 immediately after the transfer to X). Therefore, the transfer is a loss duplication transaction and A has a net built-in loss of \$2 (\$252 - \$250).

(ii) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in the PRS interest would be \$252, which would exceed the PRS interest's \$250 value immediately after the transaction. Accordingly, the PRS interest is loss duplication property.

(3) Basis in loss duplication property. X's basis in the PRS interest is \$250, computed as its \$252 basis under section 362(a), taking into account the rules under section 752, reduced by A's \$2 net built-in loss.

(4) Basis in other property. Under section 358, taking into account the rules under section 752, A has a basis of \$102 (\$247 reduced by A's \$145 share of PRS liabilities) in the X stock he receives in the transaction.

(B) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A) of this Example 8, except that A and X make an election under section 362(e)(2)(C). Under paragraph (d)(2)(i) of this section, A reduces his basis in the X stock, as determined without regard to section 362(e)(2) and this section, by the amount of A's net built-in loss that would have been applied to reduce X's basis in the PRS interest had the section 362(e)(2)(C) election not been made. In addition, no reduction is made to X's basis in the PRS interest, as determined without regard to section 362(e)(2) and this section. As a result, A's basis in the X stock is \$100 (\$102 - \$2) and X's basis in the PRS interest is \$252.

(C) Transfer of partnership interest with liability, not loss duplication transaction. The facts are the same as in paragraph (ii)(A)(1) of this Example 8, except that A's share of PRS's §1.752-1 liabilities (as defined in §1.752-1(a)(4)) is \$155. But for section 362(e)(2) and this section, X's basis in the PRS interest would be \$242 (A's basis of \$247, reduced by A's \$155 share of PRS liabilities, increased by X's \$150 share of PRS liabilities), which would not exceed the PRS interest's \$250 value immediately after the transaction. Accordingly, A's transfer of the PRS interest is not a loss duplication transaction and section 362(e)(2) and this section have no application to the transaction. Under section 362(a), X's basis in the PRS interest is \$242 and, under section 358, taking into account the rules under section 752, A has a basis of \$92 (\$247 reduced by A's \$155 share of PRS liabilities) in the X stock he receives in the transaction.

Example 9. Transactions involving S Corporations. (i) Transfer by S Corporation. (A) No section 362(e)(2)(C) election. (1) Facts. S, an S corporation as defined in section 1361(a)(1), owns Asset 1 (basis \$100, value \$70). S transfers Asset 1 to X in exchange for a single outstanding share of X stock representing all the outstanding X stock immediately after the transaction. S does not elect to treat X as a qualified subchapter S subsidiary. The transaction is one to which section 351 applies.

(2) Analysis. (i) Loss duplication transaction. S's transfer of Asset 1 is a section 362(a) transaction. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$100, which would exceed Asset 1's \$70 value immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and S has a net built-in loss of \$30 (\$100 - \$70).

(ii) Identifying loss duplication property. But for section 362(e)(2) and this section, X's basis in Asset 1 would be \$100, which would exceed Asset 1's \$70 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property.

(iii) Basis in loss duplication property. X's basis in Asset 1 is \$70, computed as its \$100 basis under section 362(a) reduced by S's \$30 net built-in loss.

(iv) Basis in other property. Under section 358(a), S has an exchanged basis of \$100 in the X stock it receives in the exchange.

(B) Section 362(e)(2)(C) election. The facts are the same as in paragraph (i)(A)(1) of this Example 9, except that S and X elect to reduce S's stock basis under section 362(e)(2). In this case, S's \$30 built-in loss (as determined in paragraph (i)(A)(2)(i) of this Example 9) that would have been applied to reduce X's basis in Asset 1 is applied to reduce S's basis in the X stock received. As a result, S's basis in the X stock is \$70 (\$100 - \$30) and X's basis in Asset 1 is \$100. The \$30 reduction to S's basis in the X stock is treated as an expense of S under section 1367(a)(2)(D) and paragraph (e)(2) of this section. As a result, the shareholders of S must reduce their bases in their S stock.

(ii) Transfer to S Corporation. (A) Basic application of section. (1) Facts. A owns Asset 1 (basis \$90, value \$60) and Asset 2 (basis \$110, value \$120). In a transaction to which section 351 applies, A transfers Asset 1 and Asset 2 to S, an S corporation as defined in section 1361(a)(1), in exchange for a single share of S stock representing all the outstanding S stock immediately after the transaction.

(2) Analysis. (i) Loss duplication transaction. A's transfer of Asset 1 and Asset 2 is a section 362(a) transaction. But for section 362(e)(2) and this section, S's aggregate basis in those assets would be \$200 (\$90 + \$110), which would exceed the aggregate value of the assets \$180 (\$60 + \$120) immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and A has a net built-in loss of \$20 (\$200 - \$180).

(ii) Identifying loss duplication property. But for section 362(e)(2) and this section, S's basis in Asset 1 would be \$90, which would exceed Asset 1's \$60 value immediately after the transaction. As a result, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, S's basis in Asset 2 would be \$110, which would not exceed Asset 2's \$120 value immediately after the transaction. As a result, Asset 2 is not loss duplication property.

(3) Basis in loss duplication property. S's basis in Asset 1 is \$70, computed as its \$90 basis under section 362(a) reduced by S's \$20 net built-in loss. The \$20 reduction to S's basis in Asset 1 does not require a reduction to A's basis in its S stock under section 1367(a)(2)(D). See paragraph (f) of this section.

(4) Basis in other property. Under section 362(a), S has a transferred basis of \$110 in Asset 2. Under section 358(a), A has a basis of \$200 in the S stock it receives in the exchange.

(B) Section 362(e)(2)(C) election. (1) Application of section to transaction. The facts are the same as in paragraph (ii)(A)(1) of this Example 9, except that A and S elect to reduce A's stock basis under section 362(e)(2)(C). In this case, A's \$20 built-in loss (as determined in paragraph (ii)(A)(2) of this Example 9) that would have been applied to reduce S's basis in Asset 1 is applied to reduce A's basis in the S stock received. As a result, A's basis in the S stock is \$180 (\$200 - \$20), S's basis in Asset 1 is \$90, and S's basis in Asset 2 is \$110.

(2) Tax consequences of subsequent disposition of transferred assets. The facts are the same as in paragraph (ii)(B)(1) of this Example 9 except that, in addition, the year after the transaction, S sells Asset 1 (basis \$90, value \$60) and Asset 2 (basis \$110, value \$120) for \$180, recognizing the \$20 net built-in loss. The loss is allocated to A and reduces A's basis in the S stock from \$180 to \$160 under section 1367(a)(2)(B). If A then sells its S stock for its \$180 value, A will recognize a gain of \$20.

Example 10. Triangular reorganizations. (i) Facts. P owns all the stock of S1 and X owns all the stock of S2. In a merger described in section 368(a)(2)(D), S2 merges with and into S1, and X receives stock of P in exchange for its S2 stock. S2 has a net built-in loss in its assets acquired by S1 in the transaction.

(ii) Analysis. The reorganization is not a section 362(a) transaction, notwithstanding that, under §1.358-6(c), P is treated as acquiring and then transferring S2's assets to S1 for purposes of determining P's adjustment to its basis in its S1 stock. Accordingly, S1's basis in the property acquired in the transaction is not determined under section 362(e)(2) and this section; it is determined under section 362(b).

Example 11. Transfer that includes property described in section 362(e)(1)(B) and property not described in section 362(e)(1)(B). (i) Facts. FC1 transfers Asset 1 (basis \$80, value \$50) and Asset 2 (basis \$120, value \$110) to DC in a transaction to which section 351 applies. Asset 1 is not property described in section 362(e)(1)(B); Asset 2 is property described in section 362(e)(1)(B).

(ii) Basis in property described in section 362(e)(1)(B). Immediately after the transfer and without regard to section 362(e)(1) or section 362(e)(2) and this section, DC's aggregate basis in property described in section 362(e)(1)(B) (Asset 2) would be \$120 under section 362(a). However, the aggregate value of such property immediately after the transfer is \$110. Accordingly, the transfer of Asset 2 is an importation of net built-in loss within the meaning of section 362(e)(1)(C) and, under section 362(e)(1), X's basis in Asset 2 would be Asset 2's value, \$110.

(iii). Application of section. (A) Analysis. (1) Loss duplication transaction. FC1's transfer of Asset 1 and Asset 2 is a section 362(a) transaction. But for section 362(e)(2) and this section, DC's aggregate basis in those assets would be \$190 (Asset 1's \$80 basis under section 362(a) + Asset 2's \$110 basis under section 362(e)(1)), which would exceed the aggregate value of the assets \$160 (\$50 + \$110) immediately after the transaction. Accordingly, the transfer is a loss duplication transaction and FC1 has a net built-in loss of \$30 (\$190 - \$160).

(2) Identifying loss duplication property. But for section 362(e)(2) and this section, DC's basis in Asset 1 would be \$80, which would exceed Asset 1's \$50 value immediately after the transaction. Accordingly, Asset 1 is loss duplication property. But for section 362(e)(2) and this section, DC's basis in Asset 2 would be \$110, which would not exceed Asset 2's \$110 value immediately after the transaction. Accordingly, Asset 2 is not loss duplication property.

(B) Basis in loss duplication property. DC's basis in Asset 1 is \$50, computed as its \$80 basis under section 362(a) reduced by FC1's \$30 net built-in loss.

(C) Basis in other property. Under section 362(e)(1), DC's basis in Asset 2 is \$110. Under section 358(a), FC1 has an exchanged basis of \$200 in the DC stock it receives in the transaction.

Example 12. Section 362(e)(2)(C) elections with respect to transfers between persons that are not required to file a U.S. return and that are not CFCs or CFPs. (i) Basic application of section. On June 30, Year 1, FC1 transfers Asset 1 to FC2 in a transaction to which section 351 applies (the original transfer) and that is therefore a section 362(a) transaction. But for section 362(e)(2) and this section, FC2's basis in Asset 1 (determined immediately after the transfer, taking into account all applicable law, including section 362(e)(1)) exceeds the value of Asset 1 immediately after the transaction. Accordingly, the transaction is a loss duplication transaction and Asset 1 is loss duplication property. FC1 and FC2 executed a written, binding agreement to apply section 362(e)(2)(C) at some point before any Section 362(e)(2)(C) Statement is filed. However, the transfer was not entered into with a view to reducing or avoiding the Federal income tax liability of any person by avoiding the application of section 362(e)(2) and this section; further, no event described in paragraph (d)(3)(ii)(E), (F), or (G) of this section occurs prior to June 30, Year 3. As a result, under paragraph (c)(2) of this section, section 362(e)(2) and this section do not apply to the transfer. Accordingly, FC2's basis in Asset 1 is determined under section 362(a), no section 362(e)(2)(C) election can be made, and any protective filing of a Section 362(e)(2)(C) Statement will have no effect.

(ii) Loss duplication property later acquired by a person required to file U.S. return. The facts are the same as in paragraph (i) of this Example 12, except that, in addition, on January 1, Year 2, FC2 transfers Asset 1 to DC in an exchange to which section 351 applies. FC2's transfer is an event described in paragraph (d)(3)(ii)(G) of this section. As a result, paragraph (c)(2) does not except the original transfer from the application of section 362(e)(2) and this section. Under paragraph (d)(3)(ii)(G) of this

section, DC must include the Section 362(e)(2)(C) Statement for the original transfer on or with its Year 2 U.S. return in order for that election to be effective. The result would be the same if, instead of FC2 transferring Asset 1 to DC, FC1 transferred its FC2 stock to DC in an exchange to which section 351 applies. (Further, if an asset transferred by FC1 or FC2 to DC is a loss asset immediately after its transfer to DC, DC's basis in that asset may be subject to section 362(e)(1).)

(iii) Party to exchange later becomes a person required to file U.S. return. The facts are the same as in paragraph (i) of this Example 12, except that, in addition, on January 1, Year 2, FC2 becomes engaged in a U.S. business. FC2's becoming engaged in a U.S. business is an event described in paragraph (d)(3)(ii)(F) of this section because it will cause FC2 to become a person required to file a U.S. return. As a result, paragraph (c)(2) of this section does not except the transfer from the application of section 362(e)(2) and this section. Under paragraph (d)(3)(ii)(F) of this section, FC2 must include the Section 362(e)(2)(C) Statement for the original transfer on or with its Year 2 U.S. return in order for the section 362(e)(2)(C) election for the original transfer to be effective.

(iv) Statement not filed with respect to designated event. The facts are the same as in paragraph (iii) of this Example 12, except that, in addition, FC1 became engaged in a U.S. trade or business on October 31, Year 1 and as a result became a person required to file a U.S. return, an event described in paragraph (d)(3)(ii)(E) of this section. As a result, paragraph (c)(2) of this section does not except the transfer from the application of section 362(e)(2) and this section. Further, in order for the election to be effective, FC1 must file the Section 362(e)(2)(C) Statement on or with its Year 1 U.S. return. See paragraph (d)(3)(ii)(E) of this section. A statement filed by FC2 on or with its Year 2 U.S. return has no effect. Thus, if FC1 does not file the statement, the election does not become effective and basis is determined under the general rule of section 362(e)(2).

(v) Nonrecognition transfer of loss duplication property outside United States, transferee later becomes engaged in U.S. trade or business. The facts are the same as in paragraph (i) of this Example 12, except that, in addition, on December 31, Year 1, FC2 transfers Asset 1 to FC3 in a transferred basis transaction. In Year 2, FC3 becomes engaged in a U.S. trade or business and as a result becomes a person required to file a U.S. return; Asset 1 is not used in or connected with the U.S. trade or business or otherwise subject to Federal income tax. FC3's becoming engaged in a U.S. trade or business is an event described in paragraph (d)(3)(ii)(F) of this section because FC3, a person who holds loss duplication property with a basis determined by FC2's basis in the property, will be required to file a U.S. return as a result of its becoming engaged in a U.S. business. As a result, paragraph (c)(2) of this section does not except the transfer from the application of section 362(e)(2) and this section. Under paragraph (d)(3)(ii)(F) of this section, FC3 must include the Section 362(e)(2)(C) Statement for the original transfer on or with its Year 2 U.S. return in order for the section 362(e)(2)(C) election for the original transfer to be effective.

(i) [Reserved].

(j) Effective/applicability date. This section applies to transactions occurring after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, unless effected pursuant to a binding agreement that was in effect prior to **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, and at all times thereafter. In addition, taxpayers may apply these regulations to transactions occurring after October 22, 2004.

Par. 4. In §1.705-1, paragraph (a)(9) is added to read as follows:

§1.705-1 Determination of basis of partner's interest.

(a) * * *

(9) For basis adjustments necessary to coordinate sections 705 and 362(e)(2), see §1.362-4(f)(i).

* * * * *

Par. 5. In §1.1367-1, a new sentence is added at the end of paragraph (c)(2) to read as follows:

§1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

* * * * *

(c) * * *

(2) * * * For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see §1.362-4(f)(ii).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805

Par. 7. In §602.101, paragraph (b) is amended by adding the following entries to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.336-2	1545-2125
1.336-4	1545-2125
* * * * *	
1.362-4	1545-2247
* * * * *	

Beth Tucker

Deputy Commissioner for Operations Support.

Approved: August 23, 2013

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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